THE RICHEBÄCHER LETTER

Monthly Analysis of Currencies and Credit Markets

Number 320 **January 2000**

The capital wealth of the community consists in the provision for future consumption already made in the shape of natural resources, of the equipment of capital goods, and the stock of unfinished goods in process. Its content is perpetually shifting. Some part of current employment is directed towards increasing provision for the future (though capital accumulation), and some part of the current consumption exhausts a provision previously made.

J.M. Keynes, *Investment and Savings*, Collected Writings, XIII

"NEW" OR "LATE" CAPITALISM?

In the last letter, we once again pointed to Corporate America's poor profit performance in recent years, expressing our astonishment that its cause or causes - really the most important question presently - is neither discussed nor even posed. Flat denial is the general response. The following quotation from a recent issue of *Business Week* is certainly symptomatic of the prevailing perception: "More than anything else, the surge in the profitability of American corporations has been at the root of the U.S. stock market's incredible run in the past years."

The odd reality is a virtual stagnation of domestic profits over the last two years. As to its causes, our preliminary answer in the last letter was: Major causes are precisely those measures that are believed to raise profits, like cost-cutting, corporate restructuring, downsizing, mergers and acquisitions. The decisive mistake intrinsic in these strategies, we said, is the general assumption that what increases the profits of a single firm will equally affect the profits of all firms if they follow suit. It's a case of "fallacy of composition" in economics, which we have repeatedly warned about. Beware of unqualified application of micro logic to macro effects.

The second major reason for the U.S. economy's poor profit performance, as we shall explain, lies in certain peculiarities of the new information technology. Elation about technical effects misleads many people to grossly exaggerated expectations about inherent economic effects. Assessing the latter, actually, requires distinguishing between three different effects: *first*, wealth creation through rising valuations of existing firms in the stock market; *second*, demand and income creation through investment spending and the related production of the new equipment; and *third*, capacity and productivity effects across the economy as the new machinery is installed.

Keynes, by the way, focused exclusively upon the demand, output and income effects of the investment spending. In his time, that was clearly the one thing to care about. The point is, productivity growth does not automatically create additional purchasing power which will buy more goods. On the contrary, it creates productive power which is made available. But it will not be employed unless some new impulse to expansion comes forward. To prevent rising unemployment through labor-saving investment, it needs corresponding demand creation in the economy. Ideally, though not implicitly, it comes from the production of the machinery.

TWO DIFFERENT KINDS OF WEALTH

For sure, within a few years this new information technology has generated fabulous wealth, running into trillions of dollars. It has been of a magnitude that is without parallel in history. However, the bulk of this wealth creation has taken place not in the economy but through capital gains in the stock market. By comparison, the wealth and income creation through the production and accumulation of the new high tech equipment has been

minimal, almost marginal. Between end-1997 and the third quarter of 1999, the production of "information processing equipment and software" increased by $113 billion, of which $25 billion was computer output - that is, 2.5% of GDP growth during this period - and $40 billion for software. These numbers have to be seen against a gross domestic product of more than $9 trillion.

On Oct. 28, 1999, the Bureau of Economic Analysis released a comprehensive benchmark revision of the national income and product accounts involving changes of unprecedented scope. Fixed investment, for example, was revised upward by more than $200 billion (chained dollars), or 16%, chiefly because business expenditures on software are now counted as additions to fixed investment, thereby adding to GDP and profit growth.

In terms of chained dollars, the gauge which alone is in the limelight of publicity and public attention, the production of computer equipment rose $136 billion to $235 billion during this period, accounting for 18.6% of GDP growth.

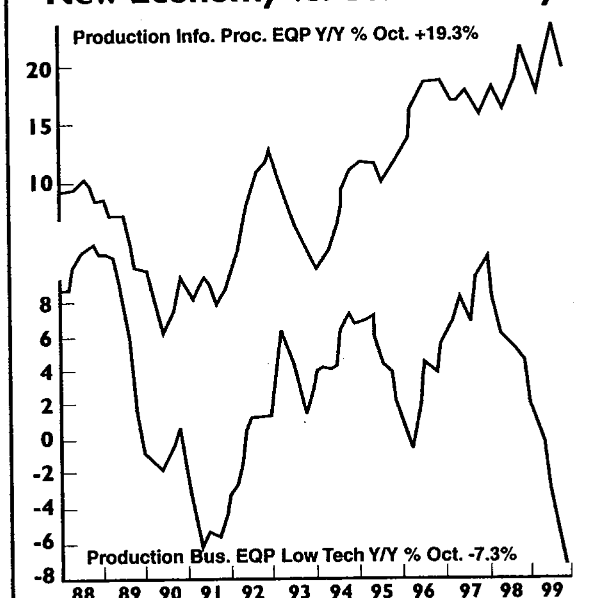
Choose your spectacles. Depending on your choice, you find two extremely different American economies. In chained dollars, you see a new paradigm economy with an extraordinary investment boom in new high tech. In current dollars, you look at an economy with unchanged slow growth in investment, productivity, profits and pay. Look at the following chart. Production of high tech equipment - but at collapsing prices - is up 19.3% year-over-year; production of business equipment in "low tech" is down 7.3%.

Now, which of the two gauges of GDP growth - chained or current dollars - is economically relevant? In our opinion, the only thing that matters are the amounts actually spent and received in current dollars. All the chained dollars exceeding these amounts in current dollars are statistical phantom dollars without any economic or financial relevance. However, the better-looking aggregates in chained dollar have all the publicity.

What, in fact, is the impact of the new technology on the economy as a whole? Trying to assess this impact, it is necessary to distinguish between three different effects: *first*, wealth effects through rising valuations (stock prices); *second*, demand, employment and income effects from associated investment in new plant and equipment (capital accumulation); and *third*, productivity and capacity effects arising from the installed new equipment. Nobody has ever made a calculation of these three effects. Our rough guess is that 95% of the total wealth and income creation derived so far from the New Information Technology has come from soaring stock prices and perhaps 5% from production and use of the equipment.

We conclude: The demand and income effects which the high tech sector (that is, the New Economy) imparts to the overall economy are pretty insignificant. Expressing it in Keynesian language, it has minimal "multiplier effects" on the economy as a whole. But this paramount shortcoming is effectively camouflaged by the peculiar way the government statisticians measure computer output in the real GDP accounts by focusing on increases in computer power.

New Economy vs. Old Economy



Source: ISO Group

CAPITAL GAINS VERSUS CAPITAL ACCUMULATION

Recently, we read in a broker report that today's technological revolution is "the greatest of its kind in history

and that it will continue to lead onwards and upwards to a brighter future." This probably expresses a widespread view, considering the sky-high valuations of this technology in the stock markets. But what matters in the long run are the income, employment and productivity effects that take place not in the markets, but in the economy and through the economy. The more we think about it, the more we realize that this Information Technology compares very miserably with corresponding effects under the Industrial Technology. It has delivered monstrous capital gains versus minimal capital accumulation.

In this respect, the Information Revolution and Industrial Revolution differ like day and night. Just think of railroadization, electrification and motorization. They dramatically changed the world and the way of life of the broad population and imparted tremendous demand and output impulses across all branches of the economies. Those innovations in their entirety created new homes, new commercial and industrial structures, new power plants, new machinery, new roads, etc.

Most importantly, the implementation of the industrial innovations required and effectively involved a prodigious input of capital and labor. Producing the equipment was both capital-intensive and labor-intensive. As a result, the related massive capital accumulation delivered egregious flows of new income and capital wealth providing rising future production and productivity. Overall, it brought about an unbelievable surge in the Wealth of Nations (Adam Smith) - soaring wealth in the shape of **real** capital resources for higher production in the future. The essence of the industrial technology was very high levels of capital accumulation, that is, high levels of investment spending and savings. This capital accumulation was the key source of the immense prosperity that the industrial technology has generated.

Always keep in mind that it is the process of capital accumulation that makes for lasting prosperity. Now compare the new information technology in this respect with the industrial technology. How much real capital formation does the production of its equipment involve? Actually, it is the outstanding distinction of the information technology that it requires minimal capital and labor input. The other day we read that this technology is the greatest technical revolution, given that the microchip is doubling its power every 18 months without any increase in costs. Ironically, that's precisely the reason why the microchip is unable to create prosperity. All incomes ultimately come from business costs.

To make one thing absolutely clear: The key determinant of the proliferating prosperity in the course of the Industrial Revolution was, in the last analysis, the abundant capital accumulation. Prolonged prosperity phases are essentially phases of high investment spending.

But hasn't the new technology created many times more billionaires within just a few years than the industrial technology did in more than 200 years? Yes, but this burst of wealth comes neither from the production nor from the application of the new technology. It comes exclusively from the soaring valuation of this technology in the stock markets, and this paper wealth adds nothing, absolutely nothing, to the economy's productive capacity. In the language of Adam Smith, it adds nothing to the Wealth of Nations. To the extent that such capital gains fuel higher consumer spending, they diminish wealth. During the 12 months until the third quarter of 1999, consumer spending accounted for 82% of GDP growth, compared to a former normal rate of 67%.

WHERE PROFITS COME FROM

Defying all the talk about economic and profit miracles, the U.S. economy's actual profit performance is the worst in all postwar cycles. First of all, the better part of the earnings "miracle" between 1992 and 1996 was produced by sharply lower interest charges and falling tax expenses. Second, profits, as measured by the government national income accounts, have virtually stagnated since 1997, even though the economy is booming. In the last

letter we promised to explain the reasons for this poor profit performance in more detail.

Proving this case begins with recalling the truism that profits are the difference between business revenues and business expenses, both being recorded in the corporate profit and loss accounts. As we shall see, the two aggregates are exposed to a variety of macroeconomic influences beyond the control of individual corporations. Answering what determines the trend of aggregate profits in an economy, therefore, needs studying the specific macroeconomic flows of funds that generate profits in the economy as a whole. "Profit sources" are flows of funds that increase business revenues in comparison to business expenses. If the money flows into the two pipes are equal, the profit meter reads zero; there is neither profit nor loss.

With these facts in mind, consider wage increases. It is generally assumed that rising wages inherently imply decreasing profits. Wrong. If the wage earners fully spend their higher earnings on domestic goods and services, business revenues will increase in lockstep with the higher costs, leaving total profits unchanged. Conversely, wage cuts are by no means the safe way to boost profits, as is generally proclaimed. If wage earners reduce their spending by the same amount, they will reduce business revenues in lockstep, leaving profits unchanged. What ultimately determines the effect on business profits is whether the increase in wages is spent or saved. Falling savings raise aggregate business revenues and profits; rising savings reduce them. It is of the utmost importance to realize this.

From a macroeconomic perspective, changes in business profits have four chief sources: first, changes in investment spending; two, changes in personal savings; three, changes in the government deficit; four, changes in the trade balance.

Investment spending, as noted in the last letter, is the most important **macroeconomic** source of profit. What's more, it is the one and only profit source under the direct control of businesses. This has an apparently strange reason: *investment spending creates business revenues without generating business expenses.* No expense is occurred until the first depreciation charges are recorded. On the other side of the transaction, the producers and sellers of the capital goods register an equivalent increase in their revenues. Taking the business sector as a whole, the net effect of higher investment spending is higher overall profits. In essence: Rising investment spending tends to boost profits in the economy as a whole. Conversely, declining investment spending tends to lower aggregate profits.

Recognizing of the crucial role of capital accumulation as the major macroeconomic corporate profit source leads to our critical conclusion that the new information technology, as well as the new corporate preferences for cost-cutting, restructuring, downsizing, mergers and acquisitions, implicitly tend to reduce aggregate profits. The reason for that is their common inherent bias to rein in new investment spending. Just think of the easiness and the minimal costs of setting up a Web site on the Internet and compare this with the heavy investment spending generally required in the "old economy."

We have no doubt that the use of the Internet will virtually explode. Yet from a strictly economic point of view, this technology is ridiculously overhyped. For the reasons explained, it will, at best, mean profitless prosperity. A case in point is Amazon.com. As an early pioneer and best-known brand name on the Net, the company ought to have earned big profits early on, if ever, before the great, established competitors stepped in. Instead, losses continue to grow faster than revenue. It seems a safe assumption that sellers will increasingly crowd into the Net with competitive offers. While Internet companies save initial capital costs, they spend fortunes on advertising in a scramble for market share and in an effort to live up to the lofty expectations of their investors. Next Christmas, very many of them will no longer be around.

If the Internet looks like heaven for buyers, it is the way to hell for sellers, mainly for two reasons: first, on their part there is sure to be intensifying competition in the Net; and second, by fiercely intensifying competition, the Net reduces overall pricing power without raising productivity growth. In short, the Internet definitely adds to the deflationary forces at work.

In our list of four major macroeconomic influences on aggregate profits, the second item is changes in personal savings, reflecting, of course, the consumer borrowing and spending binge. It has clearly been the most important profit source of Corporate America for an obvious reason: Consumer borrowing increases business revenues without generating expenses. In this respect, it equals investment spending.

But why the poor profit performance? Because the consumer's borrowing and spending binge had a second effect that destroys profits: the monstrous trade deficit. Running now at more than $300 billion annually, after $164 billion in 1998, it has become the great profit killer in the U.S. economy. How does that work? Well, just consider the source of those billions of dollars purchasing foreign goods and services. Essentially they come, directly and indirectly, from the great, ultimate well of income creation in every economy - the wage bill of the business sector. Wages emigrate to buy in foreign markets. For the American business sector as a whole, the trade deficit implies corresponding business expenses that are not recycled as revenue. In short, the trade deficit means expenses without revenue.

Last but not least, there is the government sector. In the United States, the government runs a considerable surplus. That is, it spends less than it receives. This, by the way, essentially, exerts a negative influence on the incomes of private households and businesses, regardless of low tax rates.

THE DECISIVE BREAK

Armed with the knowledge of the profit sources in capitalist economies, we can draw some important conclusions. Historically, high rates of fixed capital investment have been the key source of wealth and profit creation in the industrial world. As explained, this arose basically because the Industrial Technology involved massive capital accumulation. But that is a thing of the past. Around the world, this capital accumulation has been rapidly losing its expansive thrust. Since the 1980s America has been notorious for low investment spending. Next in this respect was Europe, then Japan and lately the rest of Asia. The ways how and why this weakness in investment spending unfolded have considerably differed, but the end-result is the same: a global decline in investment activity.

Whenever we speak of "deflation," this is actually our decisive consideration. There is a lot of talk that the prolonged, global decline in inflation rates is largely due to a global decline in pricing power. Okay, but why is that? Observing the unfettered money and credit creation that has taken place around the world during the 1990s, in particular in America, it is blatantly clear that inflation's demise must have reasons other than tight money. We have the low inflation rates not because of our central bankers, but despite them.

Given the pivotal role of capital accumulation as the engine of economic growth, we see the crucial, structural cause of the global trend toward "deflation" in the global demise of investment activity. Schumpeter would warn that this is the outstanding characteristic of a Kondratieff downgrade.

As already mentioned, this downtrend in investment spending has different causes in different regions. In Japan and Southeast Asia it began with the bursting of the investment bubbles. In Europe, the overexpansion of the social systems was most probably the main culprit. And in the United States? Increasing absorption of resources by the borrowing and spending excesses of the consumer essentially crowded out capital formation.

The new point of greatest importance to see is that this established global downtrend in capital accumulation is increasingly reinforced by two recent developments: (1) the global proliferation of Anglo-American capitalism, and (2) preponderance of "light-weight" information technology in global business investment spending.

As to the first point, Anglo-American capitalism fosters unprecedented inflation in investment values, but by depleting capital accumulation, the inherent cost-cutting and deal-making mania essentially fosters deflationary mode. New investment has fallen out of favor because it takes too long for the positive effects to show up on earnings

statements. And as for the economic impact of the new technology, it tends to deplete capital accumulation simply because it requires so little of it. Many American economists, apparently, regard the miniscule capital input inherent in the information technology as its great advantage. Since it requires less and less money to get more and more power in one chip, while the stock markets deliver ever greater wealth effects through soaring stock prices, this wonderful capitalism is supposed to allow the American public to spend all the more on consumption. Accordingly, Lawrence Kudlow declared the other day on CNBC that Americans "can now eat the cake and have it." We suspect he was expressing a mentality that characterizes the new Anglo-American capitalism.

HOLZMANN - MANNESMANN

Frankly, it stuns us how easy it is to fool the whole world for so long a time about the realities of Anglo-American capitalism and the U.S. new paradigm economy. We guess the overabundance of information offered by the new technology makes it ever more difficult for many people to distinguish between the wood and the trees. No less baffling is the general, virtually blind belief in Wall Street's pretentious claim that the shareholder value imperative has done miracles to Corporate America and the U.S. economy and that policymakers and corporate managers around the world are consequently to be judged by the degree of their acquiescence in American-style cost-cutting and deal-making capitalism.

This brings us to the worldwide outcry over Germany's chancellor Schröder, who dared to put up DM 250 million for the rescue of near-bankrupt Holzman and to express his dislike of Vodafone's hostile bid for Mannesmann. Immediately there was universal indignation and condemnation that the German economy was hopelessly stuck in its former inefficient consensus capitalism. Is it?

Not once have we seen it mentioned that Germany's manufacturing sector has been delivering annual productivity gains of 5% under this antiquated capitalism for years. Labor unit costs in the sector are down 10% since 1995. And what are the comparative figures for U.S. manufacturing? If you listen to Wall Street's Orwellian newsspeak, it must be far ahead of Germany. Well, inclusive the phony numbers for computer output, annual productivity growth since 1995 has been 4.58%. Exclusive the computer producing sector with annual productivity growth of more than 47%, it was 1.82% for durables and 2.05% for non-durables.

What counts under Anglo-American capitalism is not what happens in the factories but what happens to shareholder value. What matters most under its reign is the efficiency of corporate management in selling restructuring stories and future profit miracles with immediate effects on shareholder value. It has really become more showbusiness than capitalism. In this respect, we fear that most Germans, whether policymakers, managers or economists, will remain a permanent disappointment. The trouble with them is that in their great majority they regard the Anglo-Saxon shareholder value cult as little more than self-serving propaganda and an artifice to manipulate stock prices.

U.S. PROFIT MALAISE

Given the exuberance about the U.S. economy, its poor profit performance makes awkward reading (see table next page).

Even with record GDP growth of 5.5% at annual rate in the third quarter, profits in the nonfinancial sector were down 0.4% against the second quarter and 1% against the same quarter a year ago. This compares with an increase by 15% year-over-year in the reported profits of the S&P 500 companies. How to explain this huge difference? First, the Commerce survey covers some 20,000 companies of all sizes and stripes; and second, it provides adjustments for changing inventory values and uses a consistent measure of depreciations. By contrast, the S&P 500 earnings reflect the larger companies, many of them with sizable overseas operations. What gave the great boost to the profits of the S&P 500, apart from corporate manipulations, were two things: surging profits abroad and a jump in inventory

PROFITS WITH INVENTORY VALUATION ADJUSTMENTS, IN $BILLIONS								
				1998			1999	
Domestic industries	1997	1998	II	III	IV	I	II	III
Nonfinancial	510.9	511.5	506.0	523.7	500.6	521.9	520.6	518.2
Manufacturing	185.6	168.4	169.2	171.9	161.7	161.7	171.0	167.8
Retail	63.7	69.8	69.7	69.3	69.0	75.7	75.4	

Source: Survey of Current Business

values, especially at oil companies. Ironically, the profit performance in Europe is incomparably better than in America.

Profit margins, while still high, have been under pressure. They have been declining for two years. Non-financial businesses are earning 8.6 cents on the dollar of real output in the third quarter, down from 9.4 cents the year before.

Conventional wisdom has it that the climb of U.S. stock prices to stratospheric levels reflects miracles of corporate efficiency and profitability, resulting from rigorous restructuring and surging investment in the new technology. There is just one flaw in this happy tale: As we have again and again emphasized, profit image and profit reality have nothing in common. Overall profits have stagnated for more than two years. Yet, even these government measured profits are considerably overstated, largely but not solely owing to the rapidly spreading use of stocks options.

Considering the huge gap between actual and perceived profits, the great miracles of the new Information Age look more like the great miracles of a new Disinformation Age. Certainly, the new technology offers information as never before. But who makes efficient use of the abundance of information? When we consult analysts and economists about certain data, we overwhelmingly find ignorance and lack of interest as never before in our life. All over, there rules a very, very narrow focus on the numbers coming out of Wall Street's propaganda mills. Comments on comments on comments, that's what today goes as "research."

AND LTCM?

Inherent in this approach is the herd-like acceptance of certain ideas or slogans which tend to influence the markets. When some Wall Street economists condemn Schröder for his Holzman rescue and critical remarks about the hostile Vodafone bid as proof of Germany's outdated capitalism and warn of negative implications for the euro, you promptly read this around the whole world. And just as promptly the euro weakens. Even Mr. Duisenberg, the president of the European Central banks, was not above rehashing this rigmarole.

Observing the universal outcry about the Holzman rescue, we can't help to recall another, much greater bailout by an arm of government—a certain central bank. More significant are two differences between the two cases: first, the victims bailed out were not thousands of workers, but a den of gamblers and their reckless lenders; and second, the location was not Frankfurt, Germany, but New York, the United States. It hardly needs spelling out the name of the institution concerned: Long Term Capital Management, the giant hedge fund with a mere $4 billion in equity capital and more than $200 billion in debts.

And how did the guardians of the Holy Grail of free markets and Anglo-Saxon capitalism and all the rest respond to the government invention? With protest? No, it was greeted with overwhelming jubilation and acclaim. In any case, it gave a green light for further massively leveraged speculation in the financial markets.

WHAT MARKET FORCES?

Next, we hasten to add that we find it all too naive to believe that only government intervention is apt to falsify market prices. When one single hedge fund with $4 billion equity is able to build positions of more than $200 billion,

it should be clear that this distorts market prices. The true culprit is, or course, the unlimited availability of credit for speculation, courtesy of Mr. Greenspan.

This is the one reason why we regard the criticism of Mr. Schröder as hypocrisy. We keep asking ourselves, who else steers market forces? A striking case in this respect was the long decline of the gold bullion price. There was clearly orchestrated negative propaganda whenever the gold price moved upward. What are the market forces when highly influential American investment and commercial banks unanimously advise financial institutions and gold mines to concerted gold selling in the cash, futures and option markets?

Not only that. Through their heavy borrowing and lending of central bank gold, these banks literally organized the bear market in gold. Though being by far the biggest holder of gold reserves, Mr. Greenspan certainly did not frown upon it. More than one consideration suggests that he would certainly not shed any tears if a collapsing gold price induced more and more central banks to dump their gold holdings for dollars.

CURRENCY CONUNDRUM

Recent developments in the currency markets - the soaring yen and the plunging euro - are apt to cause similar misgivings about underlying market forces, considering that Europe's economy has considerably higher interest rates and is also obviously in far better shape than Japan. What are the market forces when the reports in the mainstream international financial press persistently display a unanimous negative spin about Europe, while reports about Japan have a just as unanimous positive spin? Good news about the euro-zone economy is flatly ignored in the currency markets, though not so in the stock markets, while bad news gets great weight. Japan is the mirror image. Bad news is completely ignored. Most of the good news is invented. The core of the bull story about Japan simply is that most businesses there have finally seen the light of Anglo-American capitalism and are aggressively restructuring.

Just one example: The euro countries have a self-imposed limit on government deficits of 2% of GDP. When the European Commission granted Italy a temporary limit of 2.4% some months ago, there was an immediate hue and cry around the world: Euroland is going soft on fiscal policy and inflation, ergo the euro must weaken, which it promptly did. Japan's government is running a budget deficit of more than 10% of GDP, and 43% of government spending is now debt-financed. Yet everybody is crying for more and more deficit spending, and nobody louder than some American policymakers and economists.

In the third quarter of 1999, Japan's economy contracted 3.8% at annual rate, and indicators suggest more of the same for the current fourth quarter. Once the public spending stream slows, the economy deflates like a balloon. Every component of domestic demand was down, in particular residential and non-residential investment. The only bright spot was net exports. Corporate profitability is so poor that many firms can't afford to invest. But the bad news in the markets was instantly discarded as a brief pause in the recovery. The yen hardly budged for a few seconds. The Bank of Japan's latest monthly report started with the following two sentences: "Japan's economy, which had stopped deteriorating, is currently turning to improve, with exports and production increasing. However, clear signs of a self-sustained recovery in private demand have not been observed yet."

A little later followed the news that the euro-zone economy had **grown** 4% at annual rate in the third quarter, paced both by stronger domestic spending and exports. Expected growth rates for 2000 and 2001 are now around 3%. But true to the established pattern to treat good news about Germany and Europe principally as state secrets, the global press in general entirely ignored this news. In hindsight, Euroland's economy has, actually, turned around in the fourth quarter of 1998, and all indicators point to further acceleration.

Given the euro's sharp fall, the low inflation rates in the region are certainly noteworthy. Since 1996, the consumer price index for the whole region has risen by a mere 4.1% overall. Consider that the currency's decline

implies a surge in the oil price by 40% and more. The inflation rate is currently at 1.2% and core inflation at 0.8%. A main factor behind it is wage restraint and very high productivity growth in the manufacturing sectors. With adjustments in the price indexes similar to those administered in recent months in the United States, Europe would have zero inflation. Owing to the drastic fiscal tightening between 1992 and 1998, the area's aggregate fiscal deficit has shrunk to the point where the OECD is now projecting a steep decline in the debt-to-GDP ratio during the next several years. Once the euro will definitely turn up against the dollar, there will be a global stampede into European bonds - mainly out of dollar bonds.

If you look at underlying fundamentals, the case for a strong euro is compelling, and without question its time will come. Clearly, however, overwhelming strong interests both in America and in Europe want sustained dollar strength against the euro. All too often, European policymakers, especially Mr. Duisenberg, publicly repeat their vow to watch the euro's slide with utter detachment, emphasizing again and again in the same breath their determination to never intervene. They virtually plead for euro weakness.

Obviously, the weak euro gives another boost to Euroland exports. Yet we presume that there is something far more important in the mind of policymakers than potential trade effects when they talk the dollar up and the euro down. The far greater and truly frightening menace lies in the effects of a sliding dollar on financial markets and capital flows. A weak dollar will put more pressure on the Fed to tighten, thereby undermining the already fragile bond and stock markets. A dollar crisis would be a disaster not only for America.

A NEW LOCOMOTIVE?

After Asia's sharp recovery came Europe's recovery. Is that the synchronized world economic upswing which is widely supposed to bring back inflation, primarily in commodity prices? Or is it perhaps the developing global "Goldilock" scenario, in which the rest of the world will provide the fuel for global growth while the U.S. economy begins to slow down.

We are more than doubtful about both. The decisive question is the source of the demand growth outside of the United States: domestic or foreign. In Europe's case, the main drag on its economic growth since mid-1997 has been trade deterioration. Conversely, the main source of the current recovery is trade improvement. The former directly reduced real GDP growth in the euro area by a full percentage point during the year ending last June, and this trade loss is now being reconquered.

The very same question essentially poses itself for all countries whose economies have sharply recovered from the 1997/98 crisis. How much of that came from domestic demand and how much from foreign trade? In most of Southeast Asia, recovery from the crisis has been dramatic, but the chief propellant was foreign trade. Korea, the most admired country in this respect, recorded a horrendous swing in its current account from minus 1.5% to plus 12.6% of GDP between 1997 to 1998. Despite a sharp slowdown, the trade surplus of the last 12 months has still accounted for 6-7% of GDP in 1999. We would say this is not the kind of growth convergence that makes a global inflationary boom.

In our view, the talk of a global boom with possible inflationary implications is misplaced. Most of the stronger economic growth in the world during 1999 has been due to the booming U.S. imports, kindly fueled by Mr. Greenspan. In the developing countries, this enormous export stimulus was supplemented by unsustainable bounces in inventory building and bursts in fiscal spending.

To give an idea of the immensity of the U.S. demand stimulus to the rest of the world, consider the following numbers. Currently, the deficit in the U.S. balance of goods and services is running at an annual rate of more than $300 billion. This compares with a deficit of $164 billion in 1998 and of $104 billion in 1997. Think of these numbers as reflecting bigger and bigger leaks in the boiler of the U.S. locomotive racing ahead at full steam.

Actually, manufacturing virtually accounts for the whole of the gap. Just for perspective, nominal U.S. GDP growth is $400 billion at annual rate.

The crucial thing to see about the economies in Europe and Asia is that their structures are traditionally geared to export- and investment-led growth. But investment spending is recovering unevenly or not at all. In Japan, it even continues to fall while the rise in Europe is moderate. An alternative American-style consumer spending boom has in both continents not the slightest chance. Compared to the United States, consumer borrowing remains grossly underdeveloped. In short, the powerful foreign locomotive that might gradually take over from the overheated American locomotive does not exist.

The conclusion to draw is that the great synchronized, global recovery with accelerating inflation is not taking place. Commodity prices have staged a modest recovery. Oil, which experienced the most dramatic rise, is a special case because its price reflects politics rather than market forces. Although the narrative runs the risks of ennui, we feel obliged to repeat that the truly great risks for the world economy lie in the unsustainable imbalances in the U.S. bubble economy.

"LATE, DEGENERATE" CAPITALISM?

Over time we have realized that what matters more than anything else in today's markets is appearance and image, not the reality of facts. Criticizing Chancellor Schröder for his remarks about Holzmann and Vodafone, ECB President Duisenberg said that "this does not enhance the image that we want to have of being an increasingly market-driven economy across the euro area." Though he found a lot of consent in the media, his remark about wanting to keep up a certain image gave us the shudders.

Up to a point, it has always been true that policymakers, managers or other people in the limelight of public opinion care about their image. Never, however, has image-creation been elevated to such an explicit, even preponderant, task of policymakers and corporate managers as presently, and the reason for that is obvious: creating a good image is an important, if not the most important, lever to raising shareholder value. All too often, there is more image-creation than positive substance. It seems obvious that the obsession with immediate effects on profits and shareholder value makes importantly for the prevailing neglect of organic growth. Doing deals and phrasemaking appear much more effective and exhilarating in boosting shareholder value.

Take the poor profit performance. Just look at the dismal profit trend, as recorded in the national income and profit accounts. But they are virtually ignored. Publicity concentrates on the reported profits of the many thousand individual companies, and there particularly on those that announce improvements. The fact that the image of a new paradigm economy delivering double-digit profit growth continues to prevail, despite the sobering profit reality, is certainly a tribute to the wizardry of Wall Street and corporate management in the United States. Presumably, many people simply take the stock prices as the proxy for corporate success.

Anglo-American capitalism has gained global credence and admiration because the U.S. statistics show an economy that has become the world's envy. There is a ready belief that these "miracles" are essentially the fruit of this new capitalism. From this presumption follows the further conclusion that policymakers and corporate managers in all countries must be judged by the degree of their abidance to the rules of Anglo-American capitalism. Dogmatic socialism is dead. Welcome dogmatic Anglo-American capitalism.

The more we have thought about this new capitalism, the more we have effectively realized that it really puts everything on its head that the historic capitalism stood for. The essence of that capitalism was capital accumulation out of savings. What is the essence of this new Anglo-American capitalism: deal-making for quick profit and inherent neglect of new investment, a dissaving public and unfettered credit creation for consumption and speculation. The mentality inherent in this capitalism, as expressed by Kudlow, is to "eat the cake and to have it."

The old capitalism had a sense of high responsibility for future generations. The horizon and the responsibility of corporate managers under the new Anglo-American capitalism begins and ends with today's stock prices.

Capitalism has always been about profits; this "late" capitalism is about greed. Yet, the decisive reason for our aversion lies in the fact that this capitalism, with its manic search for quick profits, essentially undercuts capital accumulation for the future. The effective result of this Anglo-American capitalism is that the present generation raises its living standards at the expense of future generations. In the last analysis, there are two ways that one generation can betray and burden future generations: By bequeathing them: (1) a mountain of foreign debts and (2) a depleted capital stock.

It is the great, negative peculiarity of this capitalism that the entrepreneur and the corporate manager is discouraged from building new factories because it tends to depress profits in the short run. In desperate search for quick profits, imposed by the imperative to raise shareholder value, cost-cutting, mergers and acquisitions are going to excess in Corporate America with the negative effects that we have analyzed and described. Readily, the stratospheric rise of stock prices is regarded as the direct outgrowth of this new corporate strategy, although every child meanwhile knows that this surge of valuations is chiefly courtesy of the most generous monetary accommodation by Mr. Greenspan.

In reality, this is not new capitalism but late, degenerate capitalism dominated by the most narrow-minded financial interests.

It is late, degenerate capitalism because it propels asset trading at the expense of asset creation with inherent negative effects on economic growth and overall profitability. Boosting the prices of existing capital assets is the only thing that counts. This is more than very ugly capitalism; it is really a caricature of the capitalism to which we owe our prosperity today. But to realize the hollowness of the high-riding claims of this new capitalism in the U.S. economy, it needs a closer look into the aggregate GDP numbers. As we have explained and as can easily be verified, it is the unique measurement of computer output that has put a grossly false glow on the U.S. economy's performance.

It is readily swallowed that mergers and acquisitions essentially provide enormous "synergy effects," meaning higher profitability with the effect of higher shareholder value. We are still waiting in vain for some study that confirms the validity of these claims in concrete, major cases. However, once a deal is done, interest fades into immediate oblivion. In actual fact, there are several studies of that kind. The only trouble with them is that the greater part of mergers have been failures.

The Financial Times (Nov. 29) recently reported that KPMG, one of the "Big Five" accounting and consulting firms increasingly involved in advising on mergers, had commissioned a study about the effectiveness of cross-border deals. It was carried out via confidential interviews by a third-party consultant. It covered 106 companies and the top 700-cross border deals between 1996 and 1998.

Being themselves a party with high stakes in the game, KPMG certainly hoped to prove the value of such deals. To their amazement, the study uncovered the opposite—83% of the cross-border mergers did not deliver shareholder value. In 53% of the deals, shareholder value was destroyed, while another 30% produced no discernible value. These conclusions were based on a comparison of the movement of the stock prices of the merged companies relative to those of similar competitors. What did KPMG do? They withdrew the publication of the report.

THE TAIL THAT WAGS THE DOG

The single greatest surprise in 1999, not only for us, was the persistent decline of the euro against the dollar and even more steeply against the yen, whose extraordinary strength was the other major surprise. Capital flows are the tail that wags the dog. In the case of Europe, capital outflows have exceeded the surplus in the current account,

running at about $60 billion annually. For Japan, just the reverse is true. Net capital outflows are falling short of the current-account surplus, running at an annual rate of $130 billion. In the capital flows essentially lies the explanation for the opposite movements of the two currencies.

The conventional explanation for the yen's surge is a stampede of foreign investors into Japanese stocks. Another, probably bigger, factor, in our view, has been the unwinding of the yen carry trade. Europe's capital account, on the other hand, shows huge direct investments abroad, running at about $100 billion, largely acquisitions in America. Financially strong European companies are crowding into the American market. Essentially, it's the choice of the currency for the financing of the deals that determines the currency effect. Given the rising dollar and the falling euro, there must be a preference to borrow in euro. Daimler, though, paid for Chrysler with their own stock. Still, considering the rapid progress of globalization in finance, it seems manifest that American corporations have heavily shifted their borrowing from dollar and yen to the euro, precipitating its decline of course.

Looking for any culprit, we would say that the European policymakers, chiefly Mr. Duisenberg, have unduly encouraged this shift in international borrowing by their persistent remarks not to care about the euro's decline and never to intervene.

CONCLUSIONS:

The U.S. economy and the world economy continue to be precariously propped up by unfettered U.S. consumer borrowing and spending, as reflected in the exploding U.S. trade deficit. Credit Mr. Greenspan and the stock market mania. When the U.S. asset bubble, the biggest in history, bursts, it guarantees the worst global recession in the whole postwar period.

The overwhelming majority of stocks keeps declining, not only in the United States but also around the world. But a few big-cap stocks, dominating the indexes, and the buying frenzy in the tech and Internet stocks are sustaining the false mirage of a continuing bull market.

What makes the global economic and financial situation so precarious as never before is the monstrous U.S. current-account deficit. It marks a decisive, great difference from the experience of America in 1929 and of Japan in 1990.

Looking beyond the very short term, the global economy will remain in its deflationary mode, owing to many virulent influences, but mainly overcapacity and weakening new investment. In due time, this implies interest rates. The major exception, though, will be the U.S. economy. With a plunging dollar, it is the candidate for recession with rising inflation and rising interest rates. The improving global economy and still-rising, huge U.S current account deficit point to a lower dollar, especially against the dollar.

THE RICHEBÄCHER LETTER

Dr. Kurt Richebächer, Editor
Published by The Fleet Street Group
Laura Davis, Group Publisher

Doug Noland, Market Analyst
Aimee Grable, Marketing Manager
Brian Flaherty, Design & Layout

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